Profile of the Economy

Real gross domestic product

GROWTH IN REAL GROSS DOMESTIC PRODUCT (GDP) moderated in 1995 from very high rates at the end of 1994. Growth totaled 1.4 percent over all of 1995, based on the new featured chain-weighted measure of real GDP. It is expected to sustain a modest expansionary pace that is consistent with low inflation.

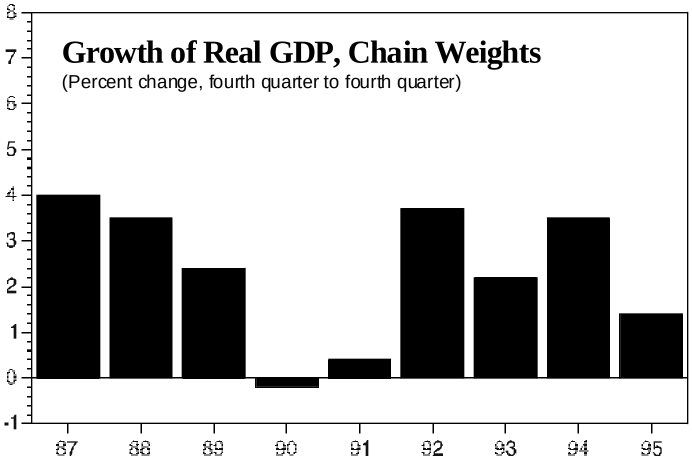
GDP grew at a very sluggish 0.5 percent rate in the first half of 1995 before accelerating to 3.6 percent in the third quarter, due to improved consumer and investment spending. Business investment spending rose at a 5.2 percent pace, while residential investment increased at a 9.2 percent rate after declining in four previous quarters.

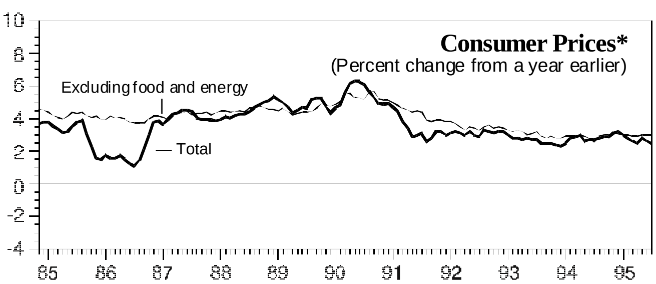
In the fourth quarter, growth slowed sharply to a 0.9 percent rate. Consumer spending moderated, and slowdowns occurred in industrial production, employment, and housing construction. Federal purchases were cut sharply by the shutdown. Some boost to growth was provided by improvement in the deficit balance in net exports, and by strong equipment investment.

Inflation, as measured by the chain-weighted price index for GDP, increased at a 2.2 percent annual rate in the fourth quarter, well below the 2.9 percent gain averaged during the first half. Prices paid by U.S. residents, excluding those for exports and including those for imports, rose at just a 2.0 percent rate, mainly due to lower oil prices.

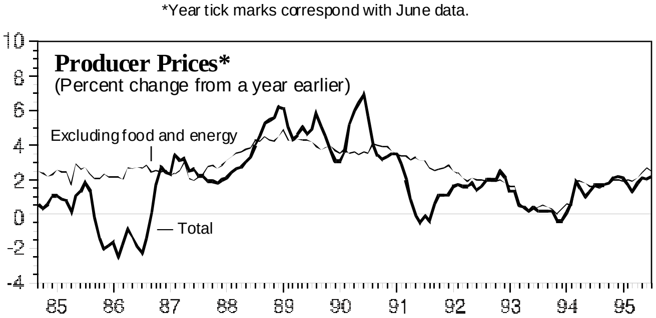
Consumer and producer prices

Inflation remained subdued as 1995 came to a close. The consumer price index (CPI) rose by only 2.5 percent during the entire year, down from 2.7 percent during both 1993 and 1994 and the second smallest increase since the mid-1960's; an oil price collapse in 1986 held consumer price inflation to only 1.1 percent that year. Contributing to the favorable performance during 1995 were a 1.3 percent decline in energy prices and a modest 2.1 percent rate of advance in food prices. Core inflation, or the CPI less food and energy, accelerated to a 3.0 percent annual rate during 1995 from only 2.6 percent over all of 1994, but that had been the smallest rise since 1965.





*Year tick marks correspond with June data.



The producer price index (PPI) for finished goods rose by 2.2 percent over the 12 months of 1995, up from increases of 0.2 percent during 1993 and 1.7 percent for 1994. The core finished goods index showed similar acceleration to 2.5 percent during 1995, but even that remains quite low.

The cost of compensating labor also shows no sign of wage pressures. The employment cost index (ECI) rose by only 2.9 percent during 1995, the smallest increase for any year going back to the early 1980's, when the series first became available.

Real disposable personal income and consumer spending

Real disposable (after tax) personal income grew at a healthy rate in the fourth quarter of last year, almost matching the 3-1/2 percent annual rate of increase in the third quarter. Through all of 1995, real income grew by roughly 2-1/2 percent, well above the 1 percent increase in 1994.

While income maintained a steady pace in the final months of 1995, real consumer spending moderated. Consumption expenditures increased by almost 3 percent at an annual rate in the third quarter, but well below that in the fourth. Holiday sales were generally lackluster, but sales of new cars and light trucks were very strong in December. Part of that strength was due to special dealer incentives, however, and car sales dropped back sharply in January.

The share of after-tax income devoted to personal saving averaged just under 5 percent in the fourth quarter and 4.4 percent over all of 1995. This compares with readings of 3.8 percent in 1994 and 4.5 percent in 1993.

Industrial production and capacity utilization

Growth of industrial production in manufacturing, mining, and utilities slowed to only about 1 percent over the course of 1995, after expanding by 6-1/2 percent during 1994. In January 1996, output fell by 0.6 percent from December, in part because severe winter storms shut down many businesses.

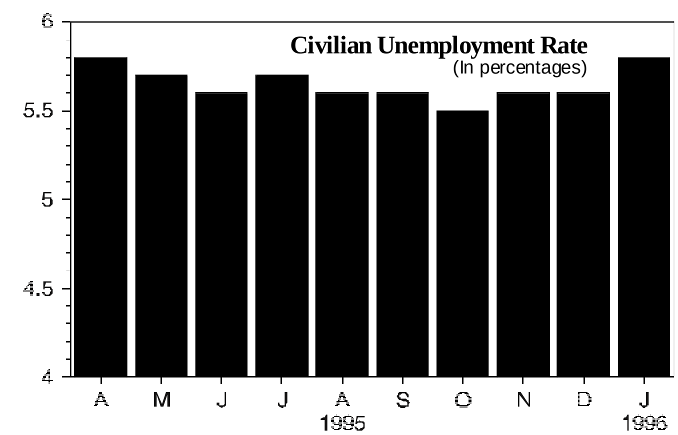
The softer market for motor vehicles and other consumer goods has also put a crimp in activity. Output of business equipment, excluding autos and trucks, remains strong and continued to grow in January. Overall, production in January was at about the same level as it had been a year earlier.

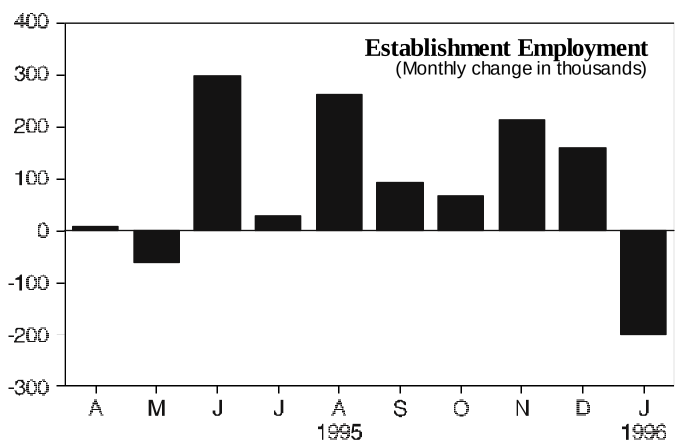
The sluggishness in industrial output has allowed the industrial capacity utilization rate to retreat from a 15-year high of 85.1 percent reached in January 1995 to 81.9 percent in January 1996. This was the first time that the utilization rate had dipped below its long-term average of 82.0 percent since November 1993.

Employment and unemployment

Job growth slowed in 1995 after accelerating in 1994, when employment growth as measured by the survey of nonfarm establishments averaged 294,000 a month, totaling 3-1/2 million new jobs over the entire year. In 1995, the pace slowed to 146,000 a month.

Weakness in manufacturing has held down overall job growth. Factory jobs fell by 253,000 between March and November after steady gains since early 1994. The private service-producing sector continued to add large numbers of new jobs in 1995, but at a much slower pace than the year before. Increases in this sector averaged 215,000 per month in 1994, but only 141,000 per month in 1995.





Employment weakened in early 1996, but severe weather and the Federal Government shutdown may have distorted the results. Employment dropped by 201,000 in January, and the workweek was cut sharply. These losses may be reversed in later months.

After dipping to a recent low of 5.4 percent in February, the unemployment rate has hovered between 5.5 and 5.8 percent for several months. This is well below levels at the start of 1994 and is quite low by historical standards.

Nonfarm productivity and unit labor costs

Nonfarm productivity, or real output per workhour, rose at a 1.4 percent annual rate in the third quarter, and by an average of a 1.1 percent pace over the first three quarters of 1995. Productivity had risen 0.7 percent during 1994. The latest figures are weaker than previously published because they have been revised to incorporate an improved measure of output, introduced recently in the GDP accounts. Productivity growth so far during the 1990's has averaged a 1.0 percent annual rate on the new basis, the same as during the 1980's, but down from 1.9 percent during the 1970's and 2.9 percent during the 1960's.

Hourly compensation costs rose at a 4.3 percent annual rate during the first three quarters of 1995, up from 2.9 percent during 1994. As a result, labor costs per unit of output in the nonfarm sector accelerated a bit to a 3.1 percent pace during the first three quarters of 1995 from about 2 percent during 1993 and 1994.

Productivity in manufacturing, a component of the nonfarm sector, remains a source of strength. Factory productivity was up at a 4.0 percent pace over the first three quarters of 1995 and unit labor costs continued to fall for a second straight year.

Current account balance

The current account balance is the most comprehensive measure of U.S. international transactions. The current account deficit has widened sharply since 1991, to $151 billion in 1994 and $162 billion at an annual rate in the first three quarters of 1995. Much of this reflects the economic recovery here which has been drawing in imports at a faster pace than the rate of expansion in exports.

A larger merchandise trade deficit accounts for most of the deterioration, although that balance has been improving since last summer. The merchandise trade deficit reached $166 billion in 1994 and $188 billion at an annual rate through the first 7 months of 1995, but fell back to a rate of $160 billion from August through November.

International trade in services shows a $63 billion surplus at an annual rate through 11 months of 1995, a little better than figures for the previous 3 years.

The balance on income payments, which includes interest, dividends, and direct investment income, shifted from a surplus of $9 billion in 1993 to a deficit of that same amount in 1994, and increased further in the first three quarters of 1995. Payments on foreign assets in the United States increased much more sharply than receipts on U.S. assets abroad, as interest rates and profits rose in this country faster than they did overseas.

Exchange rate of the dollar

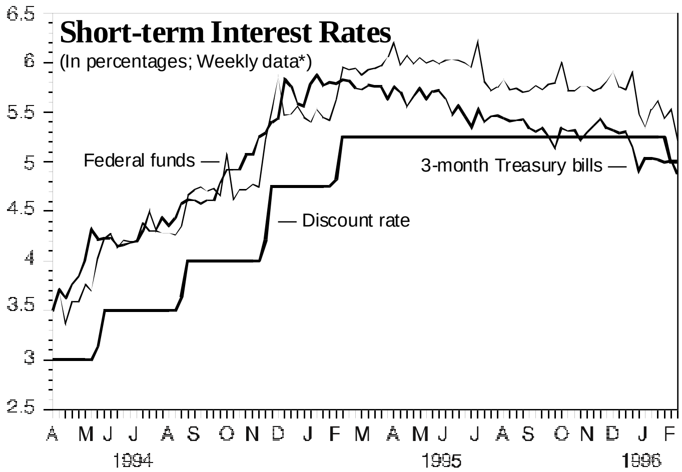
The dollar strengthened over the second half of 1995 and on into 1996 after steady deterioration beginning in early 1994. Based on the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies, the dollar increased by 5.4 percent since April, when it reached close to an all-time low. The series started in 1967.

Most of the deterioration in the dollar had been against the yen and the deutschemark, and the improvement was also greatest against these currencies. Between April 1995 and January 1996, the dollar increased by 6.0 percent against the deutschemark and by more than 25 percent against the yen.

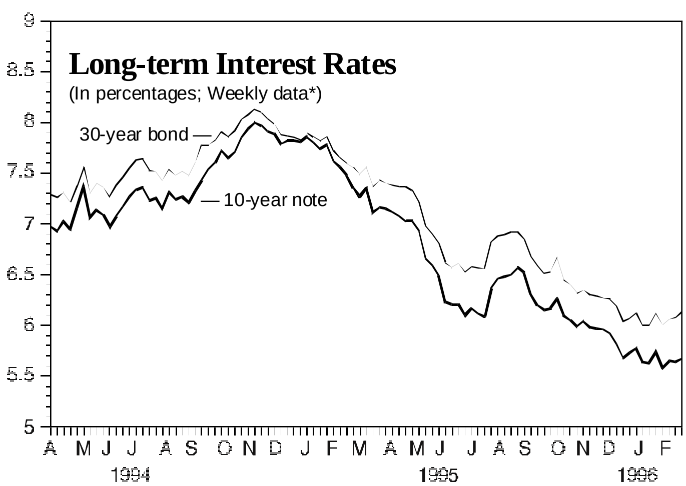
Despite the improvement, in January the dollar remained more than 10 percent below its recent high of January 1994. Many factors determine the level of exchange rates in international currency markets. The large U.S. current account deficit has likely played a role in the earlier downward movement of the dollar. Underlying economic fundamentals in the United States remain sound, however.

Interest rates

Long-term interest rates continued to decline through the end of 1995 and into 1996 as the pace of economic growth moderated and inflation pressures remained very low. The yield on the 30-year Treasury bond dipped to about the 6 percent level at the end of 1995 and in January, but recently has moved back up to about 6.3 percent.



*Average for week ending Friday; Federal funds ending Wednesday.



Mortgage interest rates are extremely favorable, edging below 7 percent in mid-February for a 30-year fixed-rate conventional loan. This is very close to the 25-year lows reached in October 1993, and compares with a rate of close to 9 percent a year ago.

Short-term interest rates have also moved lower. The Federal Reserve Board eased monetary policy in January for the third time in the current cycle, reducing by 25 basis points both the target for the Federal funds rate, to 5-1/2 percent, and the discount rate, to 5.0 percent.

Net national saving and investment

Net national saving is the saving available for investment in the expansion of structures and equipment used by U.S. workers. Depreciation to replace obsolete capital is included in gross saving. In the first three quarters of 1995, net national saving rose to 4.6 percent of net national product (NNP) from 3.9 percent in 1994 and a post-World War II trough of 2.7 percent in 1992. Net saving had averaged as high as 12 percent of NNP in the 1960's.

Gains over the past 3 years reflect the narrowing of the Federal deficit, which has reduced Government dissaving to 1.7 percent of NNP so far in 1995 from 3.9 percent in 1992. Private saving, of households and businesses, was equivalent to 6.6 percent of NNP in the first three quarters of 1995, up only a little from 6.4 percent in 1994, which was the lowest on record. Private saving had averaged nearly 10 percent of NNP in the 1960's and 1970's.

Net domestic investment equaled 7.3 percent of NNP in the first three quarters of 1995, up from lows just above 4 percent in 1991 and 1992. Foreign inflows accounted for 2.4 percent of NNP so far in 1995, or one-third of domestic investment. U.S. sources provided investment equivalent to 4.9 percent of NNP, only half the shares of NNP averaged in the 1960's and 1970's.

Housing

Housing activity leveled off towards the end of 1995 and early in 1996. Sales of both new and existing homes eased back through the fourth quarter from very high levels during the summer months, and dropped further in January due to the unusually severe winter weather across much of the country.

New construction starts have also declined, particularly for single-family homes. As sales eased, builders were left with a large inventory of unsold new homes on the market, leading to some cutbacks in construction. Construction of multi-family housing, in contrast, has remained fairly steady.

Favorable mortgage rates should continue to support the housing market, but it is unlikely there will be additional large gains. The level of housing activity remains reasonably high and should hold at that pace in future months.

Federal budget deficit

In fiscal 1995, the Federal deficit fell to $164 billion. That figure was $39 billion lower than the $203 billion deficit in fiscal 1994 and $127 billion below the record $290 billion deficit in fiscal 1992. The 3-year drop was the largest in history and the first such successive declines since the Truman Administration.

Strong economic growth and passage of the Omnibus Budget Reconciliation Act of 1993 were responsible for the improvement. Outlays rose by only 3.7 percent in fiscal 1995, while receipts expanded by 7.4 percent. The deficit represented 2.3 percent of gross domestic product (GDP) in fiscal 1995, well below the 4.7 percent share in fiscal 1992 and the lowest in 16 years.

Through the first 3 months of fiscal 1996, outlays have been well below a year earlier, mainly due to the Government shutdown and provisions of some of the continuing resolutions. Receipts have been fairly strong, reflecting growth in employment and in corporate profits. ◊